

Internal Revenue Service
memorandum

CC:TL:Br3
WOHenck

date: JAN 12 1989

to: Senior Technician Reviewer, Branch 1
Chief Counsel ISP Manager

from: Chief, Branch 3

subject: [REDACTED]

Pursuant to your request, we have studied whether collateral estoppel would apply to prevent the government from relitigating the deposit issue in the above-captioned case in subsequent years. Although the same overall fact situation is the same in subsequent years, the composition of the [REDACTED] of customers making and receiving back deposits would change from year to year. In fact, the parties stipulated to a sample of deposits as being representative of the entire group for the years in issue. Your specific request was for our views as to whether the different customers and deposit transactions would constitute separable facts in regard to the collateral estoppel doctrine.

According to the Restatement (Second) of Judgments (1982), the doctrine of collateral estoppel declares that once a court has decided an issue of fact or law necessary to its judgment, that decision is conclusive in a subsequent suit based on a different cause of action to bind a party to the prior litigation. The seminal case for the use of collateral estoppel in tax cases involving different taxable years was Commissioner v. Sunnen, 333 U.S. 591 (1948). Sunnen was an important case in the development of the collateral estoppel doctrine in federal courts, but has also been interpreted as having a special, more narrow, interpretation in the area of federal tax law. Because of this interpretation, Sunnen may remain as valid precedent for tax cases even though it has been scaled back elsewhere.

The basic holding of Sunnen is that collateral estoppel is limited in cases involving different tax years ". . . to situations where the matter raised on the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged." Id. at 599-600. The Court then went on to discuss what is known as the "separable facts" doctrine, stating, "But if the relevant facts in the two cases are separable, even though they may be similar or identical, collateral estoppel does not govern the legal issues which recur

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in the second case. Thus the second proceeding may involve an instrument or transaction identical with, but in a form separable from, the one dealt with in the first proceeding. In that situation, a court is free in the second proceeding to make an independent examination of the legal matters at issue." Id. at 601. The result of the separable facts doctrine in Sunnen was that the Court held that collateral estoppel did not apply where the issue concerned royalty payments on a separate contract which was identical to another contract which in turn had been the subject of the previous litigation.

If the Sunnen holding was the only factor in analyzing the separable facts doctrine, collateral estoppel would not apply since the deposit transactions, although essentially identical, would be different. However, there has been considerable change in this area since Sunnen. One complicating factor to consider is the "unmixed question of law" subcategory of the separable facts doctrine. A commentator has stated that Sunnen's separable facts holding in part stands for the proposition that collateral estoppel does not apply where a purely legal issue reappears in the second case. See C. Heckman, "Collateral Estoppel as the Answer to Multiple Litigation Problems in Federal Tax Law: Another View of Sunnen and The Evergreens," 19 Case Western L. Rev. 230, 239-40 (1968). The Supreme Court has addressed this situation in United States v. Moser, 266 U.S. 236 (1924), where it made a distinction between a "fact, question or right" and an "unmixed question of law." The Court determined that for the latter, "the parties in a subsequent action upon a different demand are not estopped from insisting that the law is otherwise, merely because the parties are the same in both cases." Id. at 242.

As the Tax Court in Union Carbide Corp. v. Commissioner pointed out, Sunnen, coming after Moser, recast the analysis in terms of the facts underlying a legal issue. 75 T.C. 220, 254 (1980). There has been extensive discussion of the relationship between the separable facts doctrine and the unmixed question of law analysis in cases and commentary, and quite often it can be complex. A simplified way of looking at this relationship and the progression of cases is that Moser stands for the proposition that if the underlying facts are not the same, then collateral estoppel does not apply even though the parties and legal issue are the same. Sunnen then took a more rigid view of different facts preventing collateral estoppel and in turn subsequent cases have modified Sunnen's separable facts doctrine.

The [REDACTED] decision basically consists of two parts. The Court first decided that it would use the facts and circumstances test it designed in the Indianapolis Power & Light case rather than the Eleventh Circuit Court of Appeals' "primary purpose" test to determine if the payments were deposits or advance

payments. The Court then ruled in the second part of its decision that the facts of the case indicated that the payments were deposits. An argument against the application of collateral estoppel would probably assert that the first part of the decision was an unmixed question of law and that the facts in the subsequent case were separable. The remainder of this memorandum will examine cases subsequent to Sunnen and determine if Sunnen's separable facts doctrine has retained any validity. It is our conclusion that the Tax Court would not find it controlling in this situation.

The scaling back of the separable facts doctrine began with the Supreme Court's decision in Montana v. United States, 440 U.S. 147 (1979). In Montana, a non-tax case, the Court upheld the application of collateral estoppel against the government even though the second case involved different contracts in different years with terms varying from those in the first case's contracts. The Court enumerated three factors it considered in deciding whether to apply collateral estoppel: First, whether the issues were in substance the same. Second, whether the controlling facts or the applicable law had changed. Third, whether there was a circumstance, particularly an unmixed question of law, which warranted an exception to collateral estoppel. The Court looked at the different contract terms as part of the second factor. It determined that the "controlling facts" were unchanged because the contract terms that differed were not essential to the decision in either case. Id. at 158-161. The Court did not address the fact that the contracts were separable. In its discussion of the third factor, the Court ruled that the unmixed question of law exception did not apply, because the legal issues in the two cases were "closely aligned in time and subject matter." Id. at 163.

The Ninth Circuit Court of Appeals in Starker v. United States interpreted the Montana decision as effectively removing the separable facts doctrine of Sunnen from tax as well as non-tax cases. 602 F.2d 1341, 1346 (9th Cir. 1979). The Tax Court then examined the separable facts doctrine in light of Montana in Union Carbide Corp. v. Commissioner, supra. The case revolved around the issue of whether the government was collaterally estopped from relitigating Union Carbide's computation of the foreign tax credit where the company had won a Court of Claims case for an earlier tax year when the Court had invalidated the Regulation the government was relying on in both cases. In the Tax Court, the government asserted that the facts in the Court of Claims case were similar to, but separable from, the facts in the present case and that Starker was incorrect in stating that Montana had overturned Sunnen's separable facts doctrine in federal tax litigation. The government went further and argued that there was a per se rule against the application of collateral estoppel where there were separable facts and an

unmixed question of law. 75 T.C. at 254. It supported this contention by maintaining that the government should have as much opportunity as possible to relitigate issues in order to provide for uniformity in the application of tax laws. Id. at 257-58.

The Tax Court rejected the government's arguments and applied collateral estoppel. It first quoted the Supreme Court in Montana concerning the three factors to consider in applying collateral estoppel. The Court then determined that the "controlling facts" had not changed, only the dollar amounts and years in issue. Id. at 253. The Tax Court then turned to the third factor in Montana, the possible exception to collateral estoppel for an unmixed question of law. It noted that the Sunnen decision had modified the unmixed question of law exception into an examination of the underlying facts to see if they were "separable". Id. at 254. The Court then looked to Montana for guidance and observed that the Supreme Court had used permissive language in discussing applying collateral estoppel to issues of law, which seemed to rule out a per se test. After noting that Montana involved an unmixed question of law and separate contracts, the Tax Court decided that the legal issue in the two cases involving Union Carbide were "closely aligned in time and subject matter" and therefore the unmixed question of law exception would not block collateral estoppel. Id. at 255-56. The Court then rejected the government's policy arguments, stating that there had been no change in the controlling legal principles, the first decision was not that old, and the government decided not to file a petition for certiorari in the first case, reducing the effect of its argument that it needed as much opportunity as possible to relitigate issues. Id. at 257-58. In following Montana's test for applying collateral estoppel, the Tax Court has moved away from Sunnen's holding on separable facts.

The Supreme Court returned to the separable facts/unmixed question of law area in United States v. Stauffer Chemical Co., 464 U.S. 165 (1984). The case revolved around whether private contractors are "authorized representatives" under the Clean Air Act, with Stauffer having already won on this issue in another federal district court. The issue before the Court was whether collateral estoppel applied even though the underlying factual events, although very similar, were totally separate. The government argued, as it had in Union Carbide, that Sunnen's separable facts test applied to the unmixed question of law exception. In finding for Stauffer, the Court stated that collateral estoppel applied where the same issue had already been litigated between the two parties and the two cases involved "virtually identical facts." Id. at 169.

The Court used the three factors it had set out in Montana to determine if collateral estoppel should apply. It first

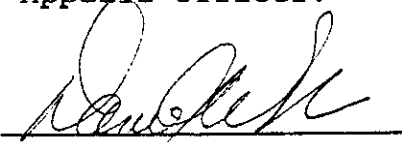
stated that the first two factors, the issues being substantially the same and the controlling facts and the law not changing, were met. Id. at 169-70. The Court addressed the unmixed question of law exception under the third Montana factor, whether there were any special circumstances which dictated not applying collateral estoppel. After reviewing the Montana holding that the unmixed question of law exception did not apply in that case because of the "close alignment of time and subject matter" between the two causes of action, the Court briefly described the factual background in Stauffer. It concluded that factual differences such as the plant locations inspected and the private contractors involved were "of no legal significance whatever in resolving the issue presented in both cases." Id. at 171-72. The Court then followed by stating that the purpose for the unmixed question of law exception was unclear, but that it would not apply in this case "to allow the Government to litigate twice with the same party an issue arising in both cases from virtually identical fact." Id. at 172. In a footnote, the Court dismissed the government's argument that the separable facts doctrine applied, remarking that whatever relevance Sunnen might have for that proposition in tax law, it was not relevant in this case. Id. at 172, n. 5.

Based on the cases just described, Sunnen's separable facts doctrine is technically still alive in the tax area, since Stauffer did not directly overturn it. However, after Montana, Union Carbide, and Stauffer, it has been severely curtailed or even eliminated as a practical matter. Montana led the way with its discussion of whether the "controlling facts" had changed or whether the cases were "closely aligned in time and subject matter" and its decision to apply collateral estoppel even though the second case involved different contracts in different years with varying terms from those contracts in the first case. Union Carbide then applied Montana's standard for collateral estoppel in a tax case. Stauffer followed by dismissing the difference in some facts between the two cases by commenting that they were not legally significant and then implicitly questioned the value of the unmixed question of law exception.

Applying this to [REDACTED], it appears that collateral estoppel would apply since the only way to avoid its application for the years before the Appeals Officer would be to contend that the facts were separable, particularly in the context that the Court's decision to use the facts and circumstances, rather than principal purpose, standard involved an unmixed question of law. Not only is the case law unfavorable, the factual background of [REDACTED] also works against setting up an argument that the separable facts doctrine prevents application of collateral estoppel. The government stipulated that a random sample of deposit transactions were representative of the entire group. It would be difficult to then maintain that the separable facts

doctrine should be rigidly applied to another random sample of deposit transactions in a subsequent year. In deciding whether to litigate the collateral estoppel issue for the years currently before the Appeals Officer, general policy considerations must also be examined. The Montana and Stauffer cases, although non-tax cases, fit better within the overall goals of the collateral estoppel doctrine than does a rigid interpretation of Sunnen's separable facts doctrine. Nor is there any apparent reason for a different standard in tax litigation. Another factor to consider is that scaling back the separable facts doctrine based on Montana and Stauffer will help the government in overall litigation as much as it will taxpayers.

There is another way to avoid collateral estoppel. It is our understanding that the Indianapolis Power case is currently on appeal in the Seventh Circuit Court of Appeals. If the Tax Court is upheld, there will be a split among the circuits. If the Supreme Court then issued a decision supporting the Eleventh Circuit's principal purpose test, rather than the Tax Court's facts and circumstances test, there would be an intervening change in law. The government would then be free to raise this issue again with [REDACTED] or the [REDACTED] operating companies. However, it is unlikely that all these events will occur in time to affect the years currently before the Appeals Officer.


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